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SUBJECT: SCANDAL CONTINUES TO RATTLE BRAZILIAN GOVERNMENT

REF: BRASILIA 0402

1. (SBU) SUMMARY. The Waldomiro Diniz scandal that broke in Brazil on February 13 (reftel) continues to reverberate, and the end is not in sight. Diniz, a deputy to Lula's Chief of Staff, Jose Dirceu, was fired when it was revealed that, as head of the Rio de Janeiro lottery authority in 2002, he solicited bribes from a numbers operator and reportedly funneled that money into several Workers' Party (PT) election campaigns. With Brazil returning to work on March 1 from the Carnaval holidays, the story remains front-page news and has spun off in different directions. VEJA magazine ran a cover story alleging further PT campaign improprieties while other media reported that Diniz continued his influence peddling even after joining the Lula administration. In that instance, the press implies that in early 2003, Diniz intervened to benefit GTech, a US firm that provides computerized lottery services. In a February 20 statement, GTech stated that two of its officials met with Diniz and others in the new administration in early 2003, and that all such talks were transparent and professional.

2. (SBU) On the political front, President Lula issued a decree banning bingo games and slot machines throughout Brazil. Congress must now vote on this measure, which is controversial because it put hundreds of thousands of gaming employees out of work. This week, Congress will also decide whether to establish a congressional inquiry (CPI) into the Diniz scandal, or more likely, into the gaming sector in general. While Congress's normal legislative agenda may be slowed by the fallout from the Diniz scandal, a political reform bill that would, inter alia, reform campaign finance rules, is on a fast track. There is no hard proof that Jose Dirceu or other PT leaders filled party slush funds with money squeezed from legal and illegal gambling operators, but there are certainly a lot of unanswered questions. While Lula's personal approval numbers remain high, his government, his party, and his Chief of Staff are taking a beating. END SUMMARY.

#### MORE CHARGES OF ILLEGAL PT CAMPAIGN FINANCING

3. (SBU) The fallout from the Waldomiro Diniz scandal that broke on February 13 is far from over. In its 2/25 issue, VEJA magazine ran an article claiming that the alleged illegal campaign financing by the Workers' Party (PT) in 2002 was not isolated to Diniz and the money he claims to have solicited for gubernatorial races in Rio and Brasilia. The article reports that Jose Vicente Brizola, who in 2002 was Director of the Rio Grande do Sul state lottery authority, was pressured by that state's PT Senator Emilia Fernandes to solicit up to R\$900,000 (about \$300,000) from bingo operators for her failed reelection bid. (Fernandes was Secretary for Women's Affairs in Lula's government until losing her job in the January 2004 cabinet reshuffle.) If true, the story would be another black eye for the PT. On the other hand, Brizola, who provided the basis for VEJA's report, is the son of former Rio governor Leonel Brizola, whose PDT party is a shrill opponent of Lula's government, and PT leaders respond that he is merely seeking revenge for not being offered a job in the administration.

4. (SBU) Also last week, Luiz Eduardo Soares, who in 2003 was fired as head of the Federal Police for hiring his wife and ex-wife as consultants, announced that while working in the Rio state government in 2002, he learned of Waldomiro Diniz's illegal fundraising for the PT, but when he brought it to the attention of party leaders, nothing was done and Diniz was left in place as head of the Rio lottery authority.

#### DINIZ'S ONGOING CORRUPTION -- US FIRM NAMED

15. (SBU) Another set of allegations has sprung up suggesting that Diniz's corrupt activities did not end when he joined President Lula's staff. The press is reporting that in 2003, while serving as a senior advisor to Lula's Chief of Staff, Diniz met with officials of US firm GTech, which holds the contract to operate Brazil's 9,000 computerized lottery parlors. Press reports indicate that Diniz met with numbers racketeer Carlinhos Cachoeira ("Charlie Waterfall") not only in the infamous 2002 videotapes (ref A), but also in early 2003, when they met with GTech officials to discuss a 25-month extension of the firm's contract. If Diniz's actions were improper, it would belie Lula's statements that Diniz's improprieties occurred before he joined the administration --it would put his corruption inside Lula's Planalto Palace. In a February 20 statement, GTech stated that its officials met with Diniz and other officials of the new administration in early 2003, and that all such talks were transparent and professional.

#### GTECH - WORLDWIDE LOTTERY OPERATOR

16. (SBU) In 1997, Brazilian firm Racimec, owned by Carlinhos Cachoeira --the lottery operator who made the videotapes of himself negotiating bribes with Waldomiro Diniz-- won a five-year contract to operate the federal lottery. Racimec was then bought by GTech, a Rhode Island company with 2003 revenues of \$979 million that operates lotteries around the world. This contract was extended through April 2003, and then re-extended for 25 more months. The GoB is GTech's single largest customer, accounting for 10% of the firm's revenues. In 2002, GTech filed a still-unresolved lawsuit against the GoB to prevent it from segmenting the lottery contract into four separate operations and thus reducing its need for GTech's services. The stakes are high, lottery proceeds are about R\$5 billion (about \$1.7 billion) annually and, of this, about one-third is earmarked for GoB social programs.

#### CONGRESS TO DECIDE ON DECREE ON BINGO'S STATUS

17. (SBU) Aside from the direct legal consequences of the scandal, there are political ramifications on at least three tracks: the legal status of national bingo games, the possibility of a congressional inquiry (CPI), and efforts to reform campaign finance laws. The first of these, the bingo games, was the subject of the President's first direct response to the scandal. On February 20, seeking to exert control over the loosely-regulated bingo games, Lula issued a presidential decree (MP 168) banning all bingo and slot machines (but not lotteries) throughout Brazil. Lula's office announced that the decree would remain in force until "a definitive solution is found". In fact, to remain in force, the decree must be voted into law by Congress within 60 days. In its first week, MP 168 survived six legal challenges filed by bingo operators, and the wave of lawsuits is not likely to abate as the police continue seizure operations that have already netted 1,200 machines.

18. (SBU) MP 168 is tricky business for Congress. While the Diniz scandal has heightened public suspicions of the gaming sector, it is estimated that between 120,000 and 320,000 gaming employees have been put out of work by the decree, and they have begun marching in the streets (one placard in Brasilia read, "Jose Dirceu, Your Job Cost Me Mine!"). This is tough medicine for an administration committed to reducing a rising tide of unemployment. The GoB concern is that bingo parlors are used to launder money, but a PT Deputy (Gilmar Machado) already had administration support for a bill that would legalize and regulate the bingo games. Further, there is a lingering suspicion that the Diniz scandal was orchestrated in part by numbers racketeers hoping to create pressure for greater legalization of gambling. With so many competing interests, it seems likely that the administration will push to get MP 168 ratified by Congress in the coming weeks, at least in part to reinforce Lula's political authority and to demonstrate that the administration and PT are moving forcefully against gambling. That might then open the door for debate on a follow-on bill, such as Machado's, to re-legalize some sort of federal bingo.

#### CONGRESSIONAL INQUIRY STILL IN THE AIR

19. (SBU) In the days after the scandal broke, party leaders in Congress argued over whether to open a congressional inquiry (CPI). The PT leadership and administration oppose a CPI in part to avoid more public shaming at the hands of

opposition politicians, but also because the GoB wants to refocus attention on its legislative agenda. There were indications before Carnaval that intense lobbying by the PT and its coalition partners had rallied enough opposition votes to kill the CPI, but a threat by a PT Senator to investigate illegal campaign financing by other parties infuriated the opposition and left the issue to be settled this week. One possible compromise is to open a CPI to look into the gaming sector in general, rather than any specific case. The Diniz case is being investigated by the Federal Police and the Federal Prosecutor's office (both of whom will take Diniz's deposition this week), and the Rio state assembly.

#### CAMPAIGN FINANCE REFORM GETS A BOOST

10. (SBU) While some of the GoB's legislative agenda is likely to be slowed by the Diniz scandal, a political reform bill has received a shot in the arm. Political reform (meaning rules changes for parties, elections, and campaign financing) was on the back burner because in this, an election year, it seemed unlikely to pass. Now, a bill that has been a year in the drafting by an ad hoc committee in the Chamber has moved forward to the Justice Committee and put in "urgent procedure", to speed its way to the floor. However, the bill is controversial and will certainly undergo changes before passing into law.

#### COMMENT - DIRCEU AND PT ARE DAMAGED

11. (SBU) There is no proof that Chief of Staff Jose Dirceu or other Workers' Party leaders filled party slush funds with money squeezed from legal and illegal gaming operators, but there are certainly a lot of unanswered questions. Dirceu has reportedly offered his resignation to Lula more than once since the scandal broke, but was rebuffed each time. Polling numbers not yet released publicly reportedly show Lula's personal approval numbers remain high, but that his government, his party, and his Chief of Staff are all suffering significantly in the public eye.

12. (SBU) It is the nature of Brazilian political scandals that leaks and revelations continue to emerge, but that weeks or months later, the whole thing goes away and only lower-level officials ever suffer legal sanction. That pattern may hold true in this case, but Dirceu, who only recently was called the "Prime Minister" and the "All Powerful" is clearly diminished, and the PT has lost much of its hard-earned reputation for probity. The separate case of Celso Daniel, the PT mayor murdered in 2002, and the reluctance by the party leadership to push a thorough investigation, also weighs against the PT. If hard evidence of large-scale campaign finance abuses is found and linked to the highest levels of the PT (Dirceu was party president during the 2002 elections), the scandal could drag on for months. The opposition parties, with their eyes on the October 2004 municipal elections, will also keep stirring the pot. Damage has been done, but it is too early to say how much worse it will get.

VIRDEN